

MICROECONOMICS: MIDTERM ONE- FEB 18TH

CHAPTER ONE AND TWO: An introduction to Economics

- What is Economics about?

1. Scarcity: The limited nature of a societies resources
2. Economics: The study of how a society manages those scarce resources
e.g. How people decide what to buy, how firms decide how much to produce, how society decides how to divide its resources

- THE 7 PRINCIPLES OF MICROECONOMICS

1. **People Face Trade-Offs**

-Cause: Scarcity exists in all societies which means that all decisions involve some kind of trade-off. Therefore, scarcity causes trade-offs.

-E.g. *Efficiency vs. Equality*

Efficiency: Getting the most from your resources

Equality: When prosperity is distributed uniformly amongst society members

Trade-Off= To achieve greater equality, you could redistribute income from wealthy to poor. But this then reduces the incentive for the wealthy to work harder and produce, therefore this shrinks the size of the economic "pie".

2. **The Cost of Something is What You Give Up to Get it**

- Cost of an Action: What you give up to get it. E.g. The cost of coming to class today was that I had to give up that extra hour that I could of been spending sleeping.
- Making decisions requires comparing the costs and benefits of alternative choices.
- The *opportunity cost* of an item is whatever must be given up to obtain it. Opportunity cost is the relevant cost of making decisions.

Examples:

- a) The opportunity cost of going to college for a year is not just the tuition, books, and fees, but also the foregone wages, such as that if you weren't in college you could be working and making wages.
- b) The opportunity cost of seeing a movie is not just the price of the ticket but the value of the time you spend in the theater, because you could of been spending this time doing something more productive with your time.

3. Rational People Think at the Margin

- * This goes along with the idea of opportunity cost, because if the opportunity cost of an action influences the action you choose to take.
- *Rational people*: Systematically and purposefully do the best they can to achieve their objectives.
- If you have an objective the idea is that you should assess the costs and benefits of an action, and you should only act if the benefits outweigh the costs. This is called making decisions by evaluating the costs and benefits of *marginal changes*, these are incremental adjustments to an existing plan.

Examples:

MB= Marginal Benefit

MC= Marginal Cost

- a) If MB exceeds MC then we should take this action.
- b) If MB is less than MC then we should not take this action.
- c) When a student considers whether to go to college for an additional year he compares the fees and foregone wages to the extra income he would earn in the long-run from obtaining a college education. The MC is the fact that he has foregone wages, and that he has to pay tuition, however the MB is that in his life time he will most likely make more money because he is better trained and will therefore get a higher paying job.

4. People Respond to Incentives

- Incentive: Something that induces a person to act, i.e. the prospect of reward or punishment.
- Rational people respond to incentives.
- *The Peltzman Effect*: A professor, Sam Peltzman, was investigating the desirability of mandatory seatbelt laws. This is proof that people do not naturally react to incentives, because if they did then they wouldn't of had to pass a mandatory seatbelt law in the first place.
- Critical Idea: When you change something, people are going to alter their behavior.

Examples:

- When gas prices rise, consumers buy more hybrid cars and fewer gas guzzling SUV's.
- When cigarette taxes increase, teen smoking will decrease.

5. Trade Can Make Everyone Better Off

*This is the general principle of comparative advantage.

- Rather than being self sufficient people can specialize in producing one good or service and exchange it for other goods.
- Countries also benefit from trade and specialization: Countries can get a better price by buying goods from abroad.

6. Markets are Usually A Good Way to Organize Economic Activity

- Market: A group of buyers and sellers (need not to be in a single location).
- "Organize Economic Activity" means determining...

General Examples:

You are selling your 1996 Mustang. You have already spent \$1000 on repairs. At the last minute, the transmission dies. You can pay \$600 to have it repaired. or sell the car "as is". In each of the following scenarios, should you have the transmission repaired? Explain.

Blue book values the car at \$6500 if the transmission works, \$5700 if it doesnt.

Benefit of fixing the transmission = $(\$6500 - \$5700) = \$800$

Therefore, it is worthwhile to have the transmission fixed.

Blue Book values the care at \$6000 if transmission works, \$5500 if it doesnt.

The benefit of fixing the transmission is only \$500 (Determined by $\$6000 - \5500)

Therefore, paying the \$600 to fix the transmission is not worthwhile.

NOTE:

The \$1000 you previously spent on repairs is irrelevant. What matters is the cost and benefit of the marginal repair (the transmission).

The change in incentives from scenario A to scenario B caused your decision to change.